U.S. Senate
Republican Policy
Committee

Larry E. Craig, Chairman
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No. 9

Legislative Notice

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S. 900 — The Financial Services Modernization Act of 1999

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Reported April 28, 1999, from the Committee on Banking, Housing, and Urban Affairs, by a party-line vote of 11-9. S. Rept. 106-44, additional views filed.

NOTEWORTHY

- The Majority Leader plans to bring S. 900 to the floor on Tuesday, May 4. At this time, he expects to be able to move to the bill without having to file cloture. S. 900 modernizes financial services and eliminates the barriers preventing banks, insurance companies, and securities firms from affiliating.

- The two main controversial issues are: (1) the inclusion of proposals to reform the Community Reinvestment Act of 1977 (CRA), and (2) the regulatory structure of the new financial institutions — whether new activities should be conducted through holding company affiliates (favored by the Federal Reserve Board) or through bank operating subsidiaries (favored by the Treasury Department).

- The Democrats oppose two CRA provisions in the bill: one provision creates a rebuttable presumption that a bank is in compliance with the CRA if for the past three years it has earned a "satisfactory" or better rating; the other provision exempts small, rural banks (with total assets of less than $100 million) from the CRA. Proponents of CRA not only oppose the provisions in the bill, but want to amend the bill to expand CRA to apply to the nonbanking affiliates and to broaden the powers of regulators to enforce CRA.

- The President sent a letter to Chairman Gramm indicating that he would veto S. 900 if it were presented to him with provisions that would "undermine the effectiveness" of CRA, if it precluded an operating subsidiary structure, if it contained "inadequate" consumer protections, or, if it expanded the ability of banks and nonfinancial firms to affiliate.

BACKGROUND

S. 900 attempts to make needed reforms to outdated financial services statutes that came into existence during the Depression. Globalization of financial services, developments in technology, and changes in the capital markets have rendered existing laws obsolete. Current laws block affiliations between and among banks, securities firms, and insurance companies. Banks are further precluded from offering most securities and insurance products. The current framework was set by the 1933 Glass-Steagall Act (which required the separation of commercial banking and investment banking) and the 1956 Bank Holding Company Act (which required the separation of banking and insurance). At that time, as amended,the intent of the legislation was to prevent banks from "gambling" on risky ventures with FDIC-insured deposits. Originally intended to protect the financial system by insulating commercial banking from other forms of risk, these laws now hamper the ability of financial institutions to diversify their products. By limiting competition, the outdated statutes also reduce incentives to develop new and more efficient products and services.

S. 900 would amend existing laws to permit affiliations among banking, securities, and insurance firms and would create a new statutory framework for the financial services industry that should lead to greater safety and soundness for the financial system, increased efficiency for financial services providers, and more choices and lower costs for consumers.

HIGHLIGHTS

S. 900 provides for the affiliation among banking and other forms of financial services and commercial enterprises. The following are the bill's main areas of reform:

- **Financial Holding Companies.** S. 900 repeals the anti-affiliation provisions of the 1933 Glass-Steagall Act to allow for the merger of banking, insurance, and securities organizations under the existing bank holding company structure. Under S. 900, bank holding companies will be allowed to engage in activities that are "financial in nature or incidental thereto." The bill establishes the Federal Reserve Board (Board) as the umbrella regulator of bank holding companies.

- **National Bank Subsidiaries.** S. 900 makes an exception to the general rule that affiliations must occur under a bank holding structure for smaller national banks — banks with assets not exceeding $1 billion. Under S. 900, these smaller national banks may affiliate with other financial service providers through operating subsidiaries rather than forming a bank holding company. The exception would apply to approximately 2,000 banks which control only 18 percent of total bank assets.

- **State Law and Insurance Sales.** States have always been the primary regulator of insurance sales and underwriting. However, some States have used their regulatory authority to discriminate against insured depository institutions. S. 900 clarifies the application of State law to affiliations and activities authorized or permitted by the bill and prohibits a State from preventing these affiliations from occurring. S. 900 does provide certain "safe harbors" as to how states may regulate insurance activities of National Banks and their affiliates without being preempted. Generally speaking, laws that are not protected under the safe harbor can be challenged if they have a discriminatory impact on banks, their subsidiaries, or affiliates.

- **Community Reinvestment Act.** S. 900 creates a rebuttable presumption that a bank is in compliance with the CRA if for the past three years it has earned a "satisfactory" or better rating. Any person challenging a bank's CRA noncompliance may still do so, but must present substantial verifiable evidence to support its claim. Unlike last year's Senate Banking Committee bill and this year's House Banking Committee bill, S. 900 does not expand CRA to apply to nonbanking activities.

BILL PROVISIONS

Title I — Facilitating Affiliation Among Banks, Securities Firms, and Insurance Companies

Subtitle A —Affiliations

Bank Holding Company Structure/Financial Activities. The bill repeals the provisions of the Glass-Steagall Act that restrict the ability of banks and securities underwriters to affiliate with one another. Generally, bank holding company affiliates will be the structure through which banks, securities firms, and insurance companies will be able to engage in a broad range of financial activities. These companies will be allowed to engage in activities that are "financial in nature" or incidental to such financial activities. The bill lists the expanded activities considered financial in nature, and includes insurance and securities underwriting and merchant banking, among others. The bill establishes the Federal Reserve Board as the umbrella regulator of bank holding companies.

To engage in the new expanded financial activities allowed under the bill, all insured depository institution subsidiaries of the bank holding company must be well capitalized and well managed; further, the bank holding company must certify to such compliance. Failure to comply with these conditions will subject the bank holding company to activities restrictions that may be imposed by the Federal Reserve Board. Noncompliance left uncorrected for more than 180 days after receiving notice from the Federal Reserve Board may subject the bank holding company to divestiture of any subsidiary insured depository institutions or to limitations on certain financial activities.

Operation of State Law/Insurance Sales. Under current law, national banks and their operating subsidiaries may sell insurance in a town with 5,000 people or fewer. Banks have used this exception to the general prohibition on insurance sales to launch major insurance operations. Courts have upheld the Office of the Comptroller of the Currency's (OCC) authority to preempt state regulations with respect to national bank insurance sales. This bill reaffirms state regulation of the business of insurance under the McCarran-Ferguson Act, and requires compliance with State insurance licensing requirements, subject to nondiscrimination requirements.

The bill preempts State laws that prevent affiliations authorized or permitted by the bill. A State may not by statute, regulation, order, interpretation, or other action "prevent or restrict" the affiliations authorized by the bill. In an effort to strike a balance between preemption of State anti-affiliation laws and the State regulation of the business of insurance, the bill creates an exception for affiliations among insured depository institutions, their subsidiaries and affiliates, and insurance underwriters. A State is permitted to review applications in order to ensure that the affiliation does not jeopardize the solvency of the underwriter, as long as State actions do not discriminate against an insured depository institution.

The bill creates various categories of State insurance sales, solicitation, and cross-marketing laws that are not subject to preemption under the bill. A State may impose certain restrictions, but the restrictions can be no more burdensome or restrictive than those in 13 enumerated safe harbors.

Subtitle B —Streamlining Supervision of Bank Holding Companies

Streamlining Bank Holding Company Supervision. The bill provides that the Federal Reserve Board will be the umbrella regulator over the bank holding company, while functional regulators continue to have supervisory authority over various holding company subsidiaries. The bill permits the Board to examine the holding company and the Board may require any bank holding company or subsidiary to submit reports it has provided to other Federal or State regulators.

To the fullest extent possible, the Federal Reserve Board is directed to focus bank holding company examinations to the holding company itself and to any subsidiary that could have a materially adverse effect on the safety and soundness of any depository institution subsidiary of the holding company. However, the Board may examine nondepository institution holding company subsidiaries only if the Board has reasonable cause to believe that the subsidiary is engaged in activities posing a material risk to an affiliated depository institution or is not in compliance with certain statutory and regulatory requirements.

The Board is prohibited from unilaterally imposing capital requirements on any nondepository bank holding company subsidiary that is in compliance with the capital requirements of another Federal regulatory authority or State insurance authority, or that is registered with the Securities and Exchange Commission (SEC) or any State as an investment adviser.

Authority of State Insurance Regulator and Securities and Exchange (SEC) Commission. The Federal Reserve Board may not require contributions of capital or assets to be made to an insured depository institution subsidiary by a bank holding company that is an insurance company, broker, or dealer registered with the SEC, if the State insurance authority or the SEC prohibits the holding company from making such a contribution because it would have a material adverse effect on the financial condition of the insurance company, broker, or dealer. The Board may order the bank holding company to divest the insured depository institution subsidiary not later than 180 days after the holding company receives notice from its functional regulator prohibiting the contribution of capital or assets. Prior to divestiture, the Federal Reserve Board may restrict or limit activities of the insured depository institution or its affiliates.

Subtitle C —Activities of National Banks

Permissible Activities. While the general approach to affiliations under the bill is through the bank holding company framework, an exception is provided to smaller national banks with total consolidated assets not exceeding $1 billion. The smaller national banks are permitted to affiliate with other financial service providers through operating subsidiaries meeting certain safety and soundness requirements. Generally, real estate development and real estate investment activities are prohibited. In order to engage in these expanded activities, a national bank and all insured depository institution affiliates must be well capitalized and well managed and receive the approval of the Comptroller (OCC). Compliance with certain safety and soundness firewalls is required.

Insurance Underwriting by National Banks. Generally, a national bank is permitted to engage in insurance activities as principal through an operating subsidiary in accordance with safety and soundness considerations of section 5136A(a) of the Revised Statutes of the United States (as added by this Act), and provided that the bank has total assets not exceeding $1 billion and is well capitalized and well managed. An exception is provided that allows a national bank to offer any "authorized insurance product" in a principal capacity. The section defines "authorized insurance product" and "insurance."

Subtitle D —National Treatment of Foreign Financial Institutions

National Treatment of Foreign Financial Institutions. Generally, if a foreign bank elects to engage in expanded financial activities under new authority granted by this Act, its "grandfather" rights under section 8(c) of the International Banking Act are terminated. The bill would give the Board explicit authority to apply comparable capital and management standards to foreign banks operating a branch or agency or owning or controlling a commercial lending company in the United States.

Title II —Insurance Customer Protections

Insurance Customer Protections. Recognizing the need to protect customers who will now be able to purchase a broader range of financial products from affiliated providers on the premises of or through banks, the bill requires Federal banking agencies jointly to promulgate customer-protection regulations. The bill would require that sales take place in an area separate from the deposit-taking area; salespersons would be required to inform potential customers about whether the products are insured or carry risks with conspicuous and readily understandable disclosures before sales occurs; and sales personnel must be appropriately licensed. The federal rules will not automatically preempt state rules, which is the case under the House Banking Committee bill. Instead, S.900 gives states three years to opt out of the federal change.

Title III —Regulatory Improvements

Meaningful Community Reinvestment Act Examinations. The bill makes CRA examinations meaningful by establishing a rebuttable presumption of CRA compliance for insured depository institutions achieving a "satisfactory" or better rating in their most recent CRA exams and in each of their CRA exams during the immediately preceding 36-month period. An institution would be deemed in compliance until its next regularly scheduled CRA exam unless substantial verifiable information demonstrating noncompliance with CRA and arising since the time of the most recent CRA exam is filed with the appropriate Federal banking agency. The appropriate Federal banking agency must determine, on a timely basis, whether the information filed by any person against an institution's CRA compliance is of a substantial, verifiable nature. The burden of proof is upon the person filing such information.

Community Reinvestment Act Exemption for Community Banks. Concerned about the cost of regulatory compliance on smaller institutions, the bill exempts small banks — banks with total assets of $100 million or less located in non-metropolitan areas — from the requirements of CRA. This exemption would, in effect, apply only to 38 percent of all banks and thrifts, which control less than 3 percent of banking assets nationally.

Title IV — Federal Home Loan Bank System Reforms

Voluntary Membership. On and after June 1, 2000, the bill would change current law to make the Federal Home Loan Bank System membership voluntary for savings and loan associations.

Expanding the Mission of the Federal Home Loan Bank System. The bill expands the types of assets which can be pledged as collateral for advances for certain institutions. Currently, only mortgage loans, mortgage-backed securities, Federal Home Loan Bank deposits, and certain other real estate assets may be used as collateral for advances. Many smaller banks are unable to hold sufficient mortgage loans to pledge as collateral. The bill would permit banks with less than $500 million in assets (community banks) to pledge small business and agricultural loans as collateral, and to use the advances to fund small business, small farm, and small agribusiness lending.

Resolution Funding Corporation (REFCorp). The bill changes the fixed REFCorp obligation from a flat fee to a percentage of system net earnings.

Management of Banks. The bill modifies the governance structure of the system to give more authority to the regional banks.

Title V — Functional Regulation of Brokers and Dealers

Definition and Treatment of Banking Products. Specifies that the SEC, with the concurrence of the Federal Reserve Board, may determine by regulation those new products which, if offered or sold by a bank, would subject it to registration with the SEC. A bank may offer or sell "traditional banking products," as defined in this section, without becoming subject to registration with the SEC.

The bill also defines "broker", "dealer", "qualified investor", and "government securities". The bill preserves the ability of banks to offer trust and services, which is especially important for smaller banks.

Title VI — Unitary Savings and Loan Holding Companies

Prohibition on New Unitary Savings and Loan Holding Companies. The bill prohibits any company engaging in commercial activities from directly or indirectly acquiring control of a thrift, except for those approved or pending as of February 28, 1999. The bill also preserves the existing transferability rights of the grandfathered thrifts.

ADMINISTRATION POSITION

The President sent Chairman Gramm a letter on March 2, 1999, prior to the Committee markup of S. 900, indicating that he would veto the bill if it were presented to him with provisions that would undermine the effectiveness of CRA, if it precluded an operating subsidiary structure, if it contained inadequate consumer protections, or if it expanded the ability of banks and nonfinancial firms to affiliate.

COST

A cost estimate was prepared by the Congressional Budget Office for S. 900 on April 22, 1999. CBO estimated that S. 900 would decrease direct spending by $42 million in 2000, and by $338 million over 2000-2004. The major budgetary impact of the bill stems from an increase in the annual payments by the Federal Home Loan Banks for interest on bonds issued by the Resolution Funding Corporation. CBO also found that revenues would decrease by $3 million in 2000, and by $15 million over 2000-20004. This revenue decrease is attributed to an estimate that it would cost $15 million for the Federal Reserve to supervise the new bank holding companies. Because the Federal Reserve System remits its surplus to the Treasury, the increased costs would reduce governmental receipts by the same amount.

CBO also found that while the bill contains a number of intergovernmental mandates as defined in the Unfunded Mandates Reform Act, those mandates would not impose significant costs on state, local, or tribal governments. CBO also found that, overall, the bill would reduce existing federal regulation of the financial services industry by relaxing certain restrictions on financial transactions throughout the economy. CBO also found that the bill would impose several new private-sector mandates which would affect the Federal Home Loan Banks, banking organizations, U.S. operations of foreign banks, and insured depository institutions that pay interest on bonds issued by the Financing Corporation. However, CBO estimates that the net direct costs of these mandates would not exceed the statutory threshold for private-sector mandates ($100 million in 1996 dollars).

OTHER VIEWS

Senators Bennett and Shelby. Filed additional views urging the Chairman to remove the $1-billion-asset limitation for use of the operating subsidiary structure.

Senator Santorum. Filed additional views expressing concern with the provision extending for three years the existing premium FICO bond interest payment assessments on institutions insured by the Bank Insurance Fund (BIF) and those by the Savings Association Insurance Fund (SAIF). Without the extension, the assessment will be equalized on January 1, 2000.

Democratic Senators. All nine Democratic Senators on the Banking Committee filed additional views. These Senators support a Daschle substitute which contains the text of last year's Senate banking bill, with the addition of a bank operating subsidiary provision supported by the Treasury Department. The Senators' views express disappointment that the Committee's majority abandoned the consensus developed last year. In particular, the views focused on Community Reinvestment Act provisions, operating subsidiaries, consumer protection provisions, and the separation of banking and commerce.

Community Reinvestment Act. The Senators expressed concern with: the failure of the Committee to expand CRA to nondepository institutions; the rebuttable presumption created by the bill (which the Minority claims is a safe harbor); and, the small-bank exemption.

Operating Subsidiaries of National Banks. The Senators support giving all national banks (not just banks with assets of $1 billion or less) the option of conducting financial activities in operating subsidiaries. Apparently, the Treasury Department has agreed in negotiations with the Democrats to some additional safeguards regarding the scope and regulation of bank subsidiaries' activities that has led to the Senators' support for the operating subsidiary option. According to the Minority Senators' views, the Treasury Department has agreed to the following: that insurance underwriting may not take place in a bank subsidiary; that the Federal Reserve should have exclusive authority to define merchant banking activities in bank subsidiaries; that the Treasury and the Federal Reserve should jointly determine which activities are "financial in nature"; that the same conditions that apply to a holding company would apply to a national bank including the need to be well capitalized and well managed; CRA compliant; and, to some additional safeguards proposed by Treasury.

Consumer Protection. The Senators express concern that the Committee bill does not include consumer protection provisions included in last year's bill. Concerns raised included provisions related to insurance sales and certain securities activities.

Banking and Commerce. The Senators argue that the Committee bill weakens the separation of banking and commerce by permitting broader combinations of banking and commerce than simply merchant banking and insurance underwriting activities. For example, they express concern with the Committee bill allowing: for "open-ended merchant banking investments"; commercial firms to acquire thrifts through the unitary holding company provision; and holding companies to engage in any nonfinancial activities that regulators believe are "complementary" to financial activities.

Senator Reed. Filed additional views expressing concern with the provisions in the Committee bill that deviate from the Democrat substitute.

POSSIBLE AMENDMENTS

Daschle.	Substitute (basically last year's Senate Banking Committee version of financial modernization).
Sarbanes.	Strike Community Reinvestment Act language and substitute with language from the Daschle substitute expanding CRA.
Sarbanes.	Substitute bank holding company structure with operating subsidiary provisions (similar to provisions included in this year's House Banking Committee bill).
Sarbanes.	Re: unitary thrift regulatory structure.
Gramm.	"Sunshine" CRA amendment.

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